

AUDITOR'S REPORT



DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

MAR 27 1998

MEMORANDUM FOR JOHN W. MAGAW, DIRECTOR
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS

FROM: Richard B. Calahan *Richard B. Calahan*
Deputy Inspector General

SUBJECT: Audited Fiscal Year 1997 Financial Statements of the
Bureau of Alcohol, Tobacco and Firearms

The attached Fiscal Year 1997 financial statements of the Bureau of Alcohol, Tobacco and Firearms were audited by Price Waterhouse, LLP, an Independent Public Accountant (IPA), under contract with the Office of Inspector General. The audit was performed in accordance with the Government Management Reform Act (GMRA) of 1994. The IPA issued the following reports which are included in the attachment:

- Report of Independent Accountants on the Financial Statements;
- Report of Independent Accountants on Internal Controls; and
- Report of Independent Accountants on Compliance with Laws and Regulations

The IPA rendered an unqualified opinion on the financial statements for the year ended September 30, 1997. The IPA's report on internal controls cited five reportable conditions relating to enhancing controls over the information security management function, improving the effectiveness of access control software, implementing standard program change control processes, evaluating telecommunications security risks, and implementing policies to rotate inspectors. None of these conditions were considered a material weakness. In addition, the report on compliance with laws and regulations disclosed no instances of noncompliance.

We have submitted a copy of the attached package to the Secretary of the Treasury and to the Assistant Secretary for Management/Chief Financial Officer for transmission to the Office of Management and Budget.

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My staff monitored the conduct of the audit and performed a quality control review of the IPAs working papers. The audit was performed in accordance with generally accepted Government auditing standards and met the requirements of the GMRA.

The IPA will issue a management letter discussing various issues that were identified during the audit, but which are not required to be included in the audit reports.

Should you or your staff have questions, you may contact me at (202) 622-1090, or a member of your staff may contact Antoine Elachkar, Director, Financial Audits Division at (202) 927-5781.

Attachment

AUDITOR'S REPORT

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Price Waterhouse



REPORT OF INDEPENDENT ACCOUNTANTS

To the U.S. Department of the Treasury Office of Inspector General and
The Director of the Bureau of Alcohol, Tobacco and Firearms

We have audited the Statement of Financial Position of the Bureau of Alcohol, Tobacco and Firearms (ATF) as of September 30, 1997 and the related Statement of Operations and Changes in Net Position for the year ended September 30, 1997. These financial statements are the responsibility of ATF's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ATF for the year ended September 30, 1996 were audited by the U.S. Department of the Treasury Office of Inspector General whose report dated April 25, 1997 expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 93-06, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, these financial statements were prepared on the basis of accounting used to conform with OMB Bulletin No. 94-01, *Form and Content of Agency Financial Statements*, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements audited by us present fairly, in all material respects, the financial position of ATF at September 30, 1997 and the results of its operations and changes in net position for the year ended September 30, 1997, in conformity with the basis of accounting described in Note 1 to the financial statements.

As discussed in Note 9, ATF, effective for the fiscal year ended September 30, 1997, adopted Statement of Federal Financial Accounting Standards No 5, *Accounting for Liabilities of the Federal Government*.

We were engaged for the purpose referred to in the first paragraph of this report. The information in the "Management's Overview" (Overview) section is not a required part of the financial statements, but is supplementary information required by OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*. We do not express an overall opinion on this

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information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with ATF management. Based on this limited work, we found no material inconsistencies with the financial statements.

In accordance with *Government Auditing Standards*, we have also issued a report dated February 9, 1998 on our consideration of ATF's internal control structure and a report dated February 9, 1998 on its compliance with laws and regulations.

Eric Waterhouse LLP

February 9, 1998
Arlington, Virginia

AUDITOR'S REPORT

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REPORT OF INDEPENDENT ACCOUNTANTS ON INTERNAL CONTROLS

To the U.S. Department of the Treasury Office of Inspector General and
The Director of the Bureau of Alcohol, Tobacco and Firearms

We have audited the financial statements of the Bureau of Alcohol, Tobacco and Firearms (ATF) as of and for the year ended September 30, 1997, and have issued our report thereon dated February 9, 1998.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 93-05, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of ATF is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that: (1) transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets; (2) funds, property, and other assets are safeguarded from loss from unauthorized use or disposition; (3) transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other relevant laws and regulations; and (4) data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of ATF for the year ended September 30, 1997, we obtained an understanding of the design of significant internal control structure policies and procedures and whether they have been placed in operation, tested certain controls, and assessed control risk in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

With respect to internal controls relevant to data that support reported performance measures, we obtained an understanding of relevant internal control structure policies and procedures

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designed to achieve the above noted control objectives, and assessed risk related to management's assertions that the data is complete and relates to events that have occurred.

We noted certain matters in the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin No. 93-06, *Audit Requirements for Federal Financial Statements*, as amended. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to meet the internal control objectives described above.

Enhance Controls Over the Information Security Management Function

Since last year's audit, ATF has further enhanced staffing for its information security function by supplementing the existing Program Manager for Information Systems Security with one staff level contract employee. However, ATF still lacks sufficient staffing resources to implement and maintain an effective automated information security function. Because of these staffing shortages, heavy reliance is placed on a systems programmer to maintain the security software, generate security software reports, and set up users with dial-up access. In addition, an employee in the Operations area is responsible for the additions, deletions and modifications of user access to mainframe systems. The resulting separation of duties weaknesses increase the potential for authorized system users to engage in improper systems-related activities. We recommend that ATF further increase staffing for the Data Security organization and ensure that only members of that staff perform data security administration tasks.

Continue to Improve Effectiveness of Access Control Software

Our work identified a number of weaknesses in the Access Control Software and related access control areas. Because of the sensitive nature of these findings, details and recommendations for correcting these weaknesses will be presented in a separate management letter to ATF.

Implement Standard Program Change Control Processes

Last year's audit identified and reported under the heading, *Implement Adequate Separation of Duties*, that ATF did not have an adequate control framework for application software changes. This condition still exists. The current process does not ensure that all program changes are consistently requested, authorized, and accepted. Without effective change controls, erroneous and unauthorized changes could be applied to ATF application systems. We recommend that ATF expedite ongoing efforts to develop, approve, and implement a bureau-wide program change control process.

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Evaluate Telecommunications Security Risks

Our review disclosed a weakness in the Telecommunications Security area. Because of the sensitive nature of these findings, details and recommendations for correcting this weakness will be presented in a separate management letter to ATF.

Implement Policies to Rotate Inspectors

The use of inspectors to review taxpayer operations is integral to the control structure for ensuring that the proper amount of excise tax is paid to ATF. In the prior year, it was noted that inspectors may be assigned on a long-term basis to perform reviews of the same taxpayer, which could be construed as an impairment of the inspector's objectivity or independence. In response to this matter, ATF has drafted policies that will set forth procedures for establishing an inspector rotation policy. These policies and procedures are expected to be issued in final form during fiscal year 1998.

Management's Response

ATF management concurs with each of the above noted findings and corresponding recommendations.

Status of Prior Year's Reportable Conditions

We followed up on the status of the nine fiscal year 1996 reportable conditions identified in the Report of the Inspector General dated April 25, 1997. That report included all five of the reportable conditions described above. We also found that ATF management's corrective actions or the existence of other mitigating controls or other factors resolved the remaining four fiscal year 1996 reportable conditions as noted below:

- Strengthen Controls Over Personnel/Payroll Processing
- Improve Procedures to Record Property and Equipment Disposals Timely
- Strengthen Controls Over the Federal Excise Tax Database
- Improve Controls Over Accountability for Seized Property

* * *

A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited or material to a performance measure or aggregation of related performance measures may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

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Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the fiscal year 1997 reportable conditions described above is a material weakness.

We also noted certain other matters involving the internal control structure that we will report to the management of ATF in a separate management letter.

This report is intended for the information of the U.S. Department of the Treasury Office of Inspector General, the Department of the Treasury, the management of ATF, and the Congress. However, this report is a matter of public record and its distribution is not limited.

Eric Waterhouse UP

February 9, 1998
Arlington, Virginia

AUDITOR'S REPORT

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REPORT OF INDEPENDENT ACCOUNTANTS ON COMPLIANCE WITH LAWS AND REGULATIONS

To the U.S. Department of the Treasury Office of Inspector General and
The Director of the Bureau of Alcohol, Tobacco and Firearms

We have audited the financial statements of the Bureau of Alcohol, Tobacco and Firearms (ATF) as of and for the year ended September 30, 1997, and have issued our report thereon, dated February 9, 1998. We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 93-06, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of ATF is responsible for complying with laws and regulations applicable to ATF. As part of obtaining reasonable assurance about whether ATF's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 93-06, *Audit Requirements for Federal Financial Statements*, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with the Federal financial management systems requirements, applicable accounting standards, and the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997.

The results of our tests disclosed no instances where ATF's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

An audit of the financial statements conducted in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 93-06, *Audit Requirements for Federal Financial Statements*, as amended, is not designed to detect whether ATF's systems are Year 2000 compliant. Further, we have no responsibility with regard to ATF's efforts to make its systems, or any other systems, such as those of ATF's vendors, service providers, or any other third parties, Year 2000 compliant or provide assurance on whether ATF has

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addressed or will be able to address all of the affected systems on a timely basis. These are responsibilities of ATF's management.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express an opinion. This report is intended for the information of the U.S. Department of the Treasury Office of Inspector General, the Department of the Treasury, the management of ATF, and the Congress. However, this report is a matter of public record, and its distribution is not limited.

Eric Waterhouse LLP

February 9, 1998
Arlington, Virginia